Oliphant, Jas. H., & Co.

High Grade Stocks

vs.

High Yield Bonds

[1918]

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This information and these statistics are not guaranteed, but have been compiled from sources we believe to be accurate

High Grade Stocks *vs.* High Yield Bonds

DURING a period of upwards of ten years this firm has adhered generally to a policy of advocating high grade stocks in preference to high yield bonds for investors seeking a comparatively high income return.

We have recognized that a large class of investors has been educated to place confidence in bonds as such and by way of indulging their preference have been led to buy bonds of inferior quality, scores of millions of which have been manufactured, as it were, for their consumption—bonds which by no true standard of analysis could be demonstrated as having other than a highly speculative character.

Countless circulars have been issued to set forth the merits of bonds of such companies as the St. Louis & San Francisco R. R., while no public offering has been made of Louisville & Nashville stock, Southern Pacific stock, etc.

The "Margin of Safety"—An Expression of Management

There is one fundamental and controlling factor which perhaps more than any other discovers the real value as investments of railroad issues. This is the "margin of safety" in earnings, by which is measured a company's ability to pay year by year its fixed charges and

thereby to preserve its financial integrity. Illustrations follow:

The case presents one company with low debt and large partnership interest; and the other the reverse.	Margin of Safety	
	Liberal	Scant
Operating Revenues	$40,000,000	$40,000,000
Net Earnings	26,000,000	26,000,000
Fixed Charges	5,000,000	13,000,000
Balance—Net Income	9,000,000	1,000,000

The company which provides for its new capital requirements in large measure out of surplus earnings or by the sale of capital stock keeps its fixed charges relatively low and increases its margin of safety, thereby enhancing its credit and protecting its financial integrity.

The company which provides for its new capital requirements by the sale of bonds exclusively increases its fixed charges and frequently reduces its "margin of safety."

Some companies have followed one policy; some another.

High yield railroad bonds with few exceptions are found to be the obligations of companies which have secured funds for capital requirements almost if not quite exclusively from creditors instead of from partners.

During the last few years railroad corporations, among others, have been subjected to severe tests and many have succumbed. With virtually no exception those companies which have financed in large measure by selling stock in contradistinction to bonds only, have weathered the financial storm and have not defaulted on their bonds. Indeed the credit of all of such has remained relatively strong as compared with other corporations.

That we may illustrate the advantage of high grade stocks as compared with so-called second grade and inferior grade bonds, we submit below a list of twenty stocks of companies which have followed what we have styled a constructive method of financing, together with a list of thirty-one separate issues of bonds, each of a different company, showing in respect of each group the approximate present prices as compared with the average prices of the year 1911. The year 1911 is chosen because the defaults by railroad companies occurred in every case subsequent to that year.

20 Dividend Paying Railroad Stocks (1911-1918)

Characteristeric feature: These companies raised funds for capital requirements in large measure by stock issues or by use of surplus earnings.

The following list comprises only common stocks.	1911 Average Price	1911 Div. %	1918 March 8 Price	1918 Div. %
Atch., Top. & Santa Fe Ry...	N. B. 108	6	86	6
Atlantic Coast Line R. R.......	128	6	92	7
Baltimore & Ohio R. R.........	102	6	55	5
Chicago & Northwestern Ry...	144	7	92	7
Chicago, Mil. & St. Paul Ry...	120	7	44	† 4
Delaware & Hudson Co........	167	9	111	9
Great Northern Ry. Pfd. (no common)..................	130	7	92	7
Illinois Central R. R...........	140	7	96	7
Lehigh Valley R. R............	N.B. 148%	10	120%	10
Louisville & Nashville R. R....	148	7	113	7
Minn., St. Paul & Sault Ste. Marie Ry..................	138	7	90	7
Nash., Chattanooga & St. Louis Ry........................	160	6	120	7
New York Central Ry.........	108	5	73	5
New York, New Haven & Hartford R. R..................	139	8	29	0
Norfolk & Western Ry........	*106	5	106	7
Northern Pacific Ry...........	124	7	86	7
Pennsylvania R. R............	122%	6	90%	6
Reading Co..................	148%	6	166%	8
Southern Pacific Co..........	115	6	87	6
Union Pacific R. R............	N.B. 150	10	123	10

*Extra dividends of 1% each were paid in 1916 and 1917.

†Dividend "deferred" in March, 1918; in the comparative calculations made in this pamphlet this dividend is considered as having been omitted.

N. B.: The prices above are approximate average prices during 1911, with deductions made of 20 points in the case of Union Pacific on account of present value of securities distributed from the Treasury, and 20% in the case of Lehigh Valley account of present value of L. V. Coal Sales Co. stock distributed. Rights accrued to stockholders in most of the companies named in the above list, but allowance has not been made in the prices. Thus "rights" issued since 1911 were valued in certain cases as follows: Atlantic Coast Line, 3%; Great Northern, 4%; Louisville & Nashville, 10%; Minneapolis, St. Paul & Sault Ste. Marie, 8%; Nashville, Chattanooga & St. Louis, 20%.

The two stocks in the above list which have shown the greatest shrinkage are St. Paul and New Haven. It must be acknowledged that rather unusual conditions obtained in these cases; the St. Paul was engaged in the construction of a trans-continental railroad; the New Haven made unusually large investments in other than strictly railroad enterprises. These two companies, however, should be included in our list because they have sold for cash large amounts of stock in carrying on their financial undertakings.

In this pamphlet companies which have sold convertible bonds which in substantial amounts have been converted into stock are referred to as having sold the stock itself.

31 Railroad Bonds (1911-1918)

Characteristic feature: These companies raised funds for capital requirements almost entirely by bond issues.

Some of the following bonds have been exchanged for other securities in reorganization.	1911 Price	1918 Price March 8
	N. B.	
Ann Arbor R. R. 1st Mtge., 4%, 1995	82	56
Chesapeake & Ohio Ry. Gen. Mtge., 4½%, 1992	101	74
Chicago & Alton Ry. 1st Lien, 3½%, 1950	68	40
Chicago & Eastern Ill. R.R. Ref., 4%, 1955	81	25 In default
Chicago, R. I. & Pacific Ry. Ref., 4%, 1934	89	64 Reorganized‡
Chicago Gt. Western Ry. 1st Mtge., 4%, 1959	84	54
Cleve., Cin., Chic. & St. L. Gen. Mtge., 4%, 1993	94	61
Colo. & Southern Ref. Mtge., 4½%, 1935	97	70
Colo. Midland R. R. 1st Mtge., 4%, 1947	64	7 In default
Denver & Rio Grande R. R. 1st and Ref. 5%, 1955	87	50 In default
Erie R. R. 1st Cons. Gen. Mtge., 4%, 1996	77	52
Kansas City Southern Ry. Ref. and Imp., 5%, 1950	100	74
Minn. & St. L. R. R. 1st & Ref., 4%, 1949	70	43
Missouri, Kans. & Tex. Ry. Gen., 4½%, 1936	86	28 In default
Missouri Pacific Ry. Conv., 5%, 1959	90	50 Defaulted*
N. Y., Chicago & St. Louis Deb., 4%, 1931	91	63
N. Y., Ontario & Western Gen., 4%, 1955	92	58
Norfolk & Southern 1st & Ref., 5%, 1961	100	62
Peoria & Eastern Ry. 1st. Gtd., 4%, 1940	92	48
Pere Marquette R. R. Ref., 4%, 1955	71	14 Defaulted*
St. Louis & S. F. Gen. Lien, 5%, 1927	88	57 Defaulted*
St. Louis So. West. Ry. Cons., 4%, 1932	79	60
Seaboard Air Line Ry. Ref., 4%, 1959	82	52

31 Railroad Bonds (1911-1918) (*Cont.*)

Some of the following bonds have been exchanged for other securities in reorganization.	1911 Price	1918 Price March 8
	N. B.	
Southern Ry. Dev. & Gen., 4%, 1956	78	61
Texas & Pacific Ry. 1st, 5%, 2000	111	85 Receivership§
Toledo, St. Louis & West. 50 yr., 4%, 1950	71	50 Receivership§
Wabash Ry. Ref., 4%, 1956	60	45 Defaulted*
Western Maryland R.R., 4%, 1952	87	60
Western Pacific Ry. 1st, 5%, 1933	90	38 Defaulted*
Wheeling & Lake Erie R. R. 1st Con., 4%, 1949	84	62 Reorganized‡
Wisconsin Central 1st Gen., 4%, 1949	93	72

*Reorganized. Price here quoted is net value of securities issued in exchange for former bonds.

‡Company has passed through Receivership during period and has been reorganized. This bond issue did not default in interest.

§Interest not in default.

N. B.: The prices above are approximate average prices during 1911. None of the companies had defaulted or were in receivership in 1911, excepting only Wheeling & Lake Erie R. R.

The above list is truly representative, comprising bonds practically all of which were widely recommended as safe investments and from which the average income return in 1911 approximated the return to be had at that time from an assorted list of high grade railroad stocks.

The Comparison of the Stocks and Bonds

The following table illustrates the outcome of the two forms of investments made in 1911. It is assumed $1,000 par value of each of the stocks and $1,000 face value of each of the bonds was purchased; the twenty stocks cost $26,450; the thirty-one bonds $26,390.

20 Stocks

($1,000 par value each; total $20,000 par value)

	1911		1918		
Cost	$26,450	Value	$18,710	Decline	29%
Income	1,380	Income	*1,280	"	7%

*This figure is calculated on basis of no dividend from Chicago, Milwaukee & St. Paul Ry. common stock, action upon same having been "deferred" by the board.

31 Bonds

($1,000 face value each; total $31,000 face value)

	1911		1918		
Cost	$26,390	Value	$16,350	Decline	38%
Income	1,320	Income	*995	"	25%

*Includes $63.50 dependent upon income.

The large majority of stocks and bonds which in 1911 were accepted as proven investment securities have declined in market value in recent years, railroad stocks and bonds not excepted.

The comparison is presented not to show the relative decline in market value, but to illustrate the more satisfactory nature of the investment in the stocks in contradistinction to the bonds in the matter of income.

The Comparison Fair

In presenting the above comparison no partiality has been shown to make the record of the stocks appear better than it has been, or that of the bonds worse. Valuable "rights" in many cases have not been credited in presenting the stocks' case and no "bad examples" have been omitted, whereas in respect of the bonds considerable present net value of bonds which defaulted is due to assessments paid by stockholders. Considering that no one of the companies whose stocks are given in our list has defaulted on its obligations and that over 40% of the bonds either (1) are in default, (2) were in default, or (3) are issues of companies which are now or were in receivership, an unusual amount of mental anguish has been shown to be an inseparable concomitant to the ownership of the bonds during the period under review.

The "Margin of Safety" Governs—Not the Clauses in Mortgage Deeds

All the arguments which have been brought to represent stocks as not so desirable as a certain class of bonds show them to be indeed very desirable. The mortgages and covenants protecting bonds frequently threaten and announce more than they perform and feed investors with a continual renovation of hope to end in a succession of disappointments.

The failure of railroad and public utility bonds to make good in times of stress can usually be traced to the

absence of a sufficient margin of safety in earnings for the protection of fixed charges, and the margin of safety in turn, as we have already stated, frequently has a direct relation to the financial policy pursued in raising corporate funds—whether on the one hand by bonds alone or on the other largely by means of stock issues.

The underlying principle of corporate financing, which we have aimed to elucidate, as a governing factor in making for the security of an investment applies not only to railroad and public utility companies but to other companies as well. In presenting the case we have compared railroad issues solely as a matter of convenience.

The Moral

The attention of investors who seek high returns from bonds should be directed to the above historical review before custom has reconciled them to the present conditions and the disparity of their discoveries to their hopes has vanished from their minds.

Those who have met with misfortune in their bond investments might well consider the following quoted remarks of a renowned moralist:

"All care about futurity proceeds upon a supposition that we know at least in some degree what will be future. Of the future we certainly know nothing, but we may form conjectures from the past; and the power of forming conjectures includes the duty of acting in conformity to that probability which we discover."

+ Bonds
+ Stocks